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SUBJECT: KARACHAGANAK: KAZAKHSTAN'S UNSUNG SUPERGIANT OIL AND GAS
FIELD

REF: (A) ASTANA 2176 (B) ASTANA 1646

11. (U) Sensitive but unclassified. Not for public Internet.

12. (SBU) SUMMARY: On December 2-4, Energy Officer toured the vast Karachaganak oil and gas field near the small town of Aksai (pop. 35,000), 40 kilometers from the Russian border in northwestern Kazakhstan. Although less well-known than its supergiant neighbors Tengiz and Kashagan, Karachaganak is one of the world's largest oil and gas condensate fields and produces 49% of Kazakhstan's natural gas and 18% of its oil. The Karachaganak Petroleum Operating BV (KPO), co-operated by Britain's BG Group and Italy's Eni under a 40-year production sharing agreement (PSA), manages the field, which contains 1.2 billion tons of oil and condensate and 1.35 trillion cubic meters of natural gas. KPO's Business Governance Controller Chris Circuit expressed concern to Energy Officer that Kazakhstan's national oil company KazMunaiGas (KMG) would make a push in 2009 for an equity stake in the project, which is the largest, most profitable PSA in Kazakhstan in which KMG does not have ownership. Field manager Tom Hanson said KPO has a "very cooperative" relationship with Gazprom, the precursor of which initially discovered the field in 1979 and established a symbiotic relationship with the field that continues to this day. Constraints on oil transportation capacity worry the consortium, particularly with the slow pace of negotiations over the expansion of the CPC pipeline, KPO's preferred export route. Managing Director Roger Fox said relations with the regional government and the local population are generally strong, although the oblast continues to levy heavy environmental fines and at least one local newspaper regularly accuses the company of violating environmental laws and standards. To the residents of Aksai and Uralsk, however, KPO is an employer of choice and a model corporate citizen known for investing in schools, roads, and hospitals. END SUMMARY.

WILL KMG DEMAND AN EQUITY STAKE?

13. (SBU) KPO, which comprises Italy's Eni (32.5%), the United Kingdom's BG Group (32.5%), Chevron (20%), and Russia's Lukoil (15%), manages the Karachaganak field under a 40-year production sharing agreement that began in 1997; BG Group and ENI alternate as lead operators of the project. BG Group's Roger Fox is the current managing director and will be replaced in October by a senior

manager from Eni. There is widespread concern among KPO partners that KMG will pressure the consortium to grant it an equity stake, particularly now that negotiations over Kashagan have concluded. (NOTE: KMG insisted that the Kashagan partners increase KMG's equity stake from 8.33% to 16.81% as compensation for cost overruns and production delays. See reftel A. END NOTE). KPO's Business Governance Controller Chris Circuit seemed resigned to the inevitability of government ownership, telling Energy Officer, "after Kashagan, we're next." According to Circuit, there are only a few people in the government who can take on an issue of this magnitude, such as KMG Vice President Maksat Idenov and Minister of Energy and Mineral Resources Sauat Mynbayev, both of whom were directly involved for several months in the Kashagan negotiations. "Now that they have finished Kashagan," he said, "they will undoubtedly continue to press us for a share. We need to stay focused on our jobs, keep things running smoothly, and not give them an excuse to make demands." Karachaganak is the largest, most visible producing asset in which the government of Kazakhstan does not have an equity stake.

OIL AND GAS PRODUCTION FIGURES

¶4. (SBU) Circuit was quick to emphasize that although KPO produces 49% of all natural gas in Kazakhstan, it not a gas project. "The sole driver is to maximize liquids," he said, noting that half of the gas produced at Karachaganak (6.6 billion cubic meters, or bcm) is reinjected into wells to maintain pressure for pumping oil and another 6.6 bcm is sold to Gazprom at rates as low as one-tenth the European price. Less than 0.5% of all gas produced is flared, which is well below the industry standard. The sprawling field covers 280 square kilometers and contains 300 wells, including 100 active wells and 200 Soviet-era wells that KPO must plug and abandon. BG Group alone has invested approximately \$5.5 billion in the project since

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¶1997. There are three main operating facilities at Karachaganak: Unit 3, the original production site established by the precursor to Gazprom, remains the main production site, generating up to 470,000 barrels of oil equivalent per day (bpd), including condensate. Unit 2 uses groundbreaking technology -- including three powerful compressors built by General Electric/Nuovo Pignone -- to separate the oil from the gas and reinject the hydrogen-sulfur gas back into producing wells. A third major facility, the Karachaganak Processing Complex (KPC), stabilizes the oil and ships it by pipeline 635 kilometers to Atyrau where it joins the CPC pipeline. In November, BG Group and Eni announced they would delay Phase III expansion, citing the capital-intensive nature of the project and the high cost of inputs. Privately, KPO's Circuit confided that the government of Kazakhstan was eager for KPO to continue current tax and royalty payments, particularly in the current financial environment, rather than allowing the consortium to make major new capital investments that would defer royalty payments until the costs were recovered, per the terms of the PSA.

SYMBIOTIC RELATIONSHIP WITH GAZPROM

¶15. (SBU) Karachaganak has a long-standing, mutually-beneficial relationship with Gazprom. In fact, the field was originally designed and developed by Soviet engineers in the 1980s as a single, fully integrated facility with the Orenburg Gas Processing plant, more than 150 kilometers to the north. To this day, according to field manager Tom Hanson, KPO has a strong, cooperative relationship with Gazprom, which owns the Orenburg Gas Processing Plant. (NOTE: Former Gazprom CEO Viktor Chernomyrdin and current CEO Alexei Miller are both former directors of the Orenburg facility. END NOTE). Hanson said he or his staff are "on the phone every day - sometimes several times a day" with Gazprom technicians in Orenburg and added, "operationally, they are very easy to deal with." Hanson also noted that all expatriate staff working at KPO have Russian visas and senior managers travel to Orenburg and/or Moscow at least quarterly. Hanson said he is aware of the government of Kazakhstan's desire to build a new gas processing plant in Kazakhstan, but he is not aware of any tangible progress.

TRANSPORTATION DILEMMA

¶16. (SBU) KPO exports more than seven million metric tons of oil per year (up to 470,000 bpd) via the CPC pipeline. Company executives are anxious for an expansion in CPC capacity, particularly once additional production comes online under Phase III. KPO ships minor volumes of crude via the Atyrau-Samara pipeline but prefers to use CPC because it offers a quality guarantee and access to global markets. Unlike Tengiz and Kashagan, KPO does not transport crude by rail and does not own rail cars or loading facilities. KPO's high-sulfur sour gas is transported to Orenburg, where it is processed and sold, including to Kazakhstan. To avoid importation of its own natural resource, the governor of the West Kazakhstan region has pushed KPO to invest in a domestic gas processing plant and domestic gas pipelines. KPO has resisted the former, but did begin construction of a gas pipeline to Uralsk, which KPO's Circuit called an "absolute nightmare" because there is no domestic network for it to connect to.

GOOD RELATIONS WITH THE OBLAST AND LOCAL POPULATION

¶17. (SBU) Managing Director Roger Fox surprisingly said that, unlike investors in Atyrau oblast, KPO has had no problem obtaining work permits from West Kazakhstan oblast officials. He also proudly noted that -- notwithstanding the highly-publicized environmental fines KPO has paid -- it is the only subsoil user in Kazakhstan to request and receive a three-year environmental permit and said that the company recently received ISO 14001 certification for its environmental management system, which will lead to a tax rebate in ¶2009. Fox praised the government's use of the "polluter pays" principle, saying Kazakhstan is ahead of most European countries in enforcing environmental standards. According to Fox, despite KPO's strong environmental record, the company continues to pay fines, particularly since the local government keeps all revenue collected for environmental violations. In 2007, according to Fox, KPO paid approximately \$8 million in fines, while it expects to pay as much

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as \$60 million in 2008, even though total emissions declined, because the local government increased fines by a factor of 15. Fox said that there is one "trashy newspaper" in Uralsk that regularly criticizes KPO for alleged harm to the environment, but he noted that it has toned down its rhetoric lately. Fox said relations with the local population are excellent, citing KPO's multi-million dollar investment in social projects in the region, including a kindergarten, museum, hospital, and highway. Fox lamented that since the oblast governor controls the allocation of KPO's social investment funds, very little is invested in Aksai itself.

TAX AND LEGAL ISSUES AT THE NATIONAL LEVEL

¶18. (SBU) Commenting on the national regulatory environment, Fox said that KPO has already paid \$650 million in crude export duties and continues to make quarterly payments -- "under duress," he emphasized (see reftel B). As for the new Tax Code, which will become effective January 1, 2009, Fox said that the new rent tax may not be applicable to KPO because it has a tax stability clause, although he wryly noted that this did not prevent the authorities from imposing the crude export duty on KPO. Finally, Fox said that the new requirement for parliament to ratify KPO's production sharing agreement in order to guarantee its tax stability would amount to "a unilateral renegotiation of the contract," which the consortium would strongly protest.

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